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# LANDLORDS OF LAST RESORT: SHOULD THE GOVERNMENT SUBSIDIZE THE MORTGAGES OF PRIVATELY-OWNED, SMALL MULTIFAMILY BUILDINGS?

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# LANDLORDS OF LAST RESORT: SHOULD THE GOVERNMENT SUBSIDIZE THE MORTGAGES OF PRIVATELY-OWNED, SMALL MULTIFAMILY BUILDINGS?

DAVID REISS\*

## INTRODUCTION

For a large part of the twentieth century, the absence of stable financing has caused difficulties for owners of small, urban, multifamily buildings.<sup>1</sup> Toward the end of the twentieth century, the secondary market for multifamily mortgages matured, which has increased to some extent the availability of credit for small-apartment-building owners.<sup>2</sup> At the same time, the small-apartment-

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\* Professor of Law, Brooklyn Law School. This Article was presented at Western New England College School of Law's 2008 "Entrepreneurship in a Global Economy" Conference. I would like to thank Stacy Caplow, Arlo Chase, Nestor Davidson, Steven Dean, and Ken Levy, as well as participants in a Brooklyn Law School faculty workshop, for helpful comments. I would also like to thank Jason Gang, William Garrett, and Philip Tucker for superb research assistance. The author also acknowledges the support of the Brooklyn Law School Summer Research Stipend Program. Finally, I would like to thank the staff of the Brooklyn Law School library for help locating a variety of difficult-to-find sources.

1. See, e.g., GEORGE STERNLIEB, *THE TENEMENT LANDLORD* 196-202 (1966) (calling for, among other things, longer term mortgage money in order to stabilize urban tenement buildings). Unless otherwise noted, I use the term "multifamily housing" to refer to buildings containing more than four units. This distinction is necessary because, historically, the Federal Housing Administration, Fannie Mae, and Freddie Mac refer to buildings with five or more units as "multifamily" and grouped two- to four-unit buildings with single-family homes. William Apgar & Shekar Narasimhan, *Enhancing Access to Capital for Smaller Unsubsidized Multifamily Rental Properties* 1 (Joint Ctr. for Hous. Studies of Harvard Univ., Paper No. RR07-8, 2007), available at [http://www.jchs.harvard.edu/publications/rental/revisiting\\_rental\\_symposium/papers/rr07-8\\_apgar.pdf](http://www.jchs.harvard.edu/publications/rental/revisiting_rental_symposium/papers/rr07-8_apgar.pdf). Where noted, I may refer to buildings with two- to four-units as multifamily as well. See Emily N. Zietz, *Multifamily Housing: A Review of Theory and Evidence*, 25 J. REAL EST. RES. 185, 186 (2003) (cataloging various definitions of "multifamily housing").

2. Joint Ctr. for Hous. Studies of Harvard Univ., *Meeting Multifamily Housing Finance Needs During and After the Credit Crisis: A Policy Brief* 4 (2009) [hereinafter *MEETING MULTIFAMILY HOUSING FINANCE NEEDS*], available at [http://www.jchs.harvard.edu/publications/finance/multifamily\\_housing\\_finance\\_needs.pdf](http://www.jchs.harvard.edu/publications/finance/multifamily_housing_finance_needs.pdf) ("The multifamily finance system in the United States is effective, credit-worthy, and

building housing stock is shrinking due to abandonment, demolition, foreclosure, and other causes.<sup>3</sup> Because small apartment buildings house many low-income families, scholars affiliated with Harvard University's Joint Center for Housing Studies (the "Joint Center") have suggested that financing costs for the owners of such buildings should be subsidized in order to protect this affordable housing stock and its occupants. The most well-developed proposal arising from this sentiment is for the federal government to sponsor small Real Estate Investment Trusts (S-REITs) to pool ownership of multiple properties, which would allow small-building owners to accrue a number of significant government subsidies.<sup>4</sup>

There is, however, no major market failure in the mortgage market for small multifamily buildings even though such mortgages tend to be more expensive than mortgages for large multifamily buildings.<sup>5</sup> Moreover, available subsidies are likely to be used more efficiently if larger buildings were subsidized because the underwriting of mortgages has high fixed costs.<sup>6</sup> Finally, it is unclear if landlords will pass on a meaningful portion of the subsidy to tenants. Thus, such a proposal should not be implemented.

This Article has two goals. First, to provide as thorough a history of the small-apartment owner and small multifamily properties as can be cobbled together from the existing literature. This will fill the need for a comprehensive overview of this important, yet relatively unexplored, portion of the housing stock. And second, to use the S-REIT proposal as a lens with which to evaluate the role the government should play in the continued viability of this segment of the housing stock.

This Article proceeds as follows. First, it describes what little is known about the owners of small multifamily properties and the properties themselves. Second, it describes the lending environ-

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unlike the single-family system has maintained strong underwriting throughout the decade."'). The Joint Center study focuses on the impact of the credit crisis on the multifamily sector. *See generally id.* This Article does not directly address the impact of the ongoing credit crisis on the multifamily housing sector. Rather, it addresses structural issues that preceded—and in all likelihood will follow—the credit crisis.

3. *See* JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., AMERICA'S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY 20 (2008) [hereinafter AMERICA'S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY], available at [http://www.jchs.harvard.edu/publications/rental/rh08\\_americas\\_rental\\_housing/rh08\\_americas\\_rental\\_housing.pdf](http://www.jchs.harvard.edu/publications/rental/rh08_americas_rental_housing/rh08_americas_rental_housing.pdf).

4. *See infra* note 90 and accompanying text.

5. *See infra* notes 115-118 and accompanying text.

6. *See infra* text accompanying notes 54-55.

ment faced by real-estate entrepreneurs over the last hundred years. Finally, it concludes by arguing against proposals to implement affordable housing goals by subsidizing small-apartment-building owners.

#### I. THE SMALL-MULTIFAMILY-PROPERTY OWNER AND THE SMALL MULTIFAMILY PROPERTY

Owners of small, urban, multifamily buildings are often thought of as “slumlords.” George Sternlieb and Robert Burchell challenged the image of the “slumlord” as the most appropriate one to describe the typical small-time landlord.<sup>7</sup> This is because the small-apartment-building owner is not a homogenous category. While the category does include the archetypical slumlord, it also includes the occupant-owner of a very small multi-unit building; the amateur real-estate investor who invests excess capital in a tax-advantaged real-estate transaction; the realtor or other real-estate professional whose business expands to include management and ownership of real estate; the first-generation immigrant looking to enter the middle class through ownership of real estate; the absentee, and typically passive, investor; as well as the speculator.<sup>8</sup> And indeed, as the vitality of cities has increased from the mid-twentieth century to the early twenty-first century, the “slumlord” has begun

7. GEORGE STERNLIEB & ROBERT W. BURCHELL, *RESIDENTIAL ABANDONMENT: THE TENEMENT LANDLORD REVISITED* 54 (1973); *see also* LAWRENCE FRIEDMAN, *GOVERNMENT AND SLUM HOUSING: A CENTURY OF FRUSTRATION* 39 (1968) (arguing that the “tenement house movement helped fix [the slumlord] in his permanent position as an American devil and scapegoat”); Michael A. Stegman, *Slumlords and Public Policy*, 33 J. AM. INST. PLAN. 419, 421 (1967) (stating that George Sternlieb helps “dispel[ ] the myth of slumlords as a monolithic group of misanthropes who derive their livelihoods in units of human suffering rather than in dollars of rental receipts”).

8. *See* MICHAEL A. STEGMAN, *HOUSING INVESTMENT IN THE INNER CITY: THE DYNAMICS OF DECLINE* 27 (1972) (finding a similarly diverse group of landlords, although with greater concentration of ownership among real-estate professionals, in study of Baltimore); STERNLIEB, *supra* note 1, at 121-84 (describing many types of multifamily-building owners found in his study of Newark); *see also* FRIEDMAN, *supra* note 7 (reviewing studies from multiple jurisdictions that demonstrated that many slum landlords lived in or near their properties); Alan Mallach, *Landlords at the Margins: Exploring the Dynamics of the One to Four Unit Rental Housing Industry* 23 (Joint Ctr. for Hous. Studies of Harvard Univ., Paper No. RR07-15, 2007), *available at* [http://www.jchs.harvard.edu/publications/rental/revisiting\\_rental\\_symposium/papers/rr07-15\\_mallach.pdf](http://www.jchs.harvard.edu/publications/rental/revisiting_rental_symposium/papers/rr07-15_mallach.pdf) (arguing that in “the final analysis, there is no such thing as a typical owner” of one- to four-unit properties). Another often overlooked type of owner is the “inadvertent” landlord who had initially purchased the rental building (often a single-family) as her primary residence, only to move on to another property while retaining the first as an investment. *Id.* at 27-28.

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to give way to the “urban pioneer” as a prevailing image we have of the owner of small, urban rental properties.<sup>9</sup>

There are few facts that we know about these landlords in general (a category that also includes owners of single-unit rental properties).<sup>10</sup> Indeed, the absolute breadth of the “landlord” class seems to bear out the fact that no one stereotype can capture the

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9. See STERNLIEB & BURCHELL, *supra* note 7, at 53 (describing the folk figure of the slumlord as an “overfed individual” who is “securing a more than adequate return on his properties”). In the popular imagination, rental housing is most often located in urban areas. And, indeed, the facts bear this out: more than half of all rental units are located within ten miles of the central business districts of the ninety-one largest metro regions in the country. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION’S HOUSING 22* (2006) [hereinafter *THE STATE OF THE NATION’S HOUSING* (2006)], available at <http://www.jchs.harvard.edu/publications/markets/son2006/son2006.pdf>. Moreover, California, Florida, New York, and Texas, the four most populous states, “account for 41 percent of multifamily properties and 42 percent of multifamily units.” Amy S. Bogdon & James R. Follain, *Multifamily Housing: An Exploratory Analysis Using the 1991 Residential Finance Survey*, 7 J. HOUSING RES. 79, 84 (1996). The “urban pioneer” is a bit of catchall slang for those who choose to move to “transitional areas.” See MICH. DEP’T OF LABOR & ECON. GROWTH, 2005 COOL CITIES GRANTS & PLANNING PROGRAMS PRE-BID WORKSHOP FREQUENTLY ASKED QUESTIONS 1 (2005) (on file with author), defining “urban pioneer” as

a person who had vision for a blighted urban area who moved into the area and worked to restore the neighborhood. We now think of the term to describe anyone who lives in an urban neighborhood or moves to an urban neighborhood to either restore or maintain it. Some of those urban pioneers are empty nesters, young knowledge workers, developers, immigrants, creative workforce, or persons with passion for their city who believe in building or rebuilding a vibrant community. No matter what age a person is, one who moves into a transitional area to be part of the rebirth of that neighborhood. An urban pioneer can also be a developer who is investing in the neighborhood.

*Id.*

10. There is really a surprising lack of research in this area, a problem that goes back quite far into the twentieth century. See, e.g., J. E. MORTON, *URBAN MORTGAGE LENDING: COMPARATIVE MARKETS AND EXPERIENCE* 16 (1956) (noting that it is typically impossible to disaggregate multifamily finance data from commercial and industrial finance data); Arthur D. Sporn, *Empirical Studies in the Economics of Slum Ownership*, 36 LAND ECON. 333, 333 (1960) (“[S]eriously documented studies of the economics of owning and renting substandard housing are rare.”); see also James R. Follain, *Some Possible Directions for Research on Multifamily Housing*, 5 HOUSING POL’Y DEBATE, 533, 543 (1994) (noting that academic literature on multifamily housing and multifamily housing finance is scarce); Kerry D. Vandell, *Multifamily Finance: A Pathway to Housing Goals, a Bridge to Commercial Mortgage Market Efficiency*, 11 J. HOUSING RES. 319, 320 (2000) (noting that there is less data available on conditions in the multifamily market than on the single-family market); cf. COMMUNITY HOUSING IMPROVEMENT PROGRAM [CHIP], PHASE 2 STUDY: EXPANDED SURVEY OF OWNERS OF RENT STABILIZED PROPERTY 14 (2009) (report prepared by Urbanomics, on file with author) (noting that “[r]elatively little data has been collected on individual owners of rent stabilized properties throughout [New York] City” and that the present study only represents the “[Rent Stabilization Association] certified member universe”).

entirety: some 4.3 million households reported earning rental income from a second property (not necessarily multifamily) in the 2001 Residential Finance Survey.<sup>11</sup> The survey also found that individuals and married couples owned 19.3 million rental units, including eighty-four percent of one- to four-unit properties and sixty-five percent of five- to nineteen-unit properties.<sup>12</sup> These owners tend, unsurprisingly, to be older and wealthier than the general population at large,<sup>13</sup> although a surprisingly large number of owners are low-income themselves.<sup>14</sup>

Small “multifamily rentals are likely to be owned by individuals with few property holdings.”<sup>15</sup> Owners of smaller properties typically manage their properties themselves in order to save on the

11. THE STATE OF THE NATION’S HOUSING (2006), *supra* note 9, at 23. Of the 4.3 million who earn rental income, 3.4 million report owning only one rental property and at least one third of that 3.4 million own a single-family rental unit. *Id.* The 2001 Residential Finance Survey is part of the decennial U.S. Census. See Residential Finance Survey—Overview, <http://www.census.gov/hhes/www/rfs/overview.html> (last visited Apr. 2, 2010). It should be noted that there are few sources of data about landlords that are regularly updated. As such, this Article will make reference to various studies from the last twenty years. The reader should rely on the older studies with care, as the multifamily market has changed significantly during that period.

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12. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION’S HOUSING 21 (2007) [hereinafter THE STATE OF THE NATION’S HOUSING (2007)], available at <http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf>. Business organizations and other institutions owned 15.6 million rental units. *Id.*; JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., AMERICA’S RENTAL HOUSING: HOMES FOR A DIVERSE NATION 22 (2006) [hereinafter AMERICA’S RENTAL HOUSING: HOMES FOR A DIVERSE NATION], available at [http://www.jchs.harvard.edu/publications/rental/rh06\\_americas\\_rental\\_housing.pdf](http://www.jchs.harvard.edu/publications/rental/rh06_americas_rental_housing.pdf) (“According to the Property Owners and Managers Survey (POMS)—perhaps the most comprehensive look at owner characteristics—most individuals have fewer than ten rental units, and many have just one.”). For a thorough study of the one- to four-family housing stock, see Mallach, *supra* note 8. Mallach finds that “[n]early half of all owners of single family detached rental properties own only a single property, with another quarter owning two to four properties, while 70 percent of the owners of two-family rental properties own either one or two properties.” *Id.* at 19. Individuals and couples own in excess of eighty percent of all one- to four-family rental units. *Id.* at 20; see also LENORE SCHLOMING & SKIP SCHLOMING, THE ROAD HOME: WORKING WITH SMALL PROPERTY OWNERS TO PRESERVE AND CREATE AFFORDABLE RENTAL HOUSING, available at [http://www.pioneerinstitute.org/pdf/bgc\\_roadhome.pdf](http://www.pioneerinstitute.org/pdf/bgc_roadhome.pdf) (last visited Apr. 21, 2010).

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13. THE STATE OF THE NATION’S HOUSING (2007), *supra* note 12, at 21.

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14. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION’S HOUSING 23 (2002) [hereinafter THE STATE OF THE NATION’S HOUSING (2002)], available at <http://www.jchs.harvard.edu/publications/markets/Son2002.pdf> (“Many nonresident owners of nine or fewer rental units have low incomes themselves, with almost a third reporting annual incomes of under \$30,000.”).

15. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION’S HOUSING 21 (2001) [hereinafter THE STATE OF THE NATION’S HOUSING (2001)], available at <http://www.jchs.harvard.edu/publications/markets/SON2001.pdf>.

fees that would have to be paid to a professional manager.<sup>16</sup> That being said, for most of these owners, managing their properties is at most a part-time job.<sup>17</sup> Not infrequently, they reside in their properties.<sup>18</sup>

There is also some useful data about smaller multifamily properties themselves, as distinct from the owners of such properties.<sup>19</sup> These smaller properties make up a large share of the multifamily market: buildings with fewer than fifty units make up 88.5% of multifamily properties, and those with fewer than twenty units make up 74.9% of multifamily properties.<sup>20</sup> While small buildings make up the bulk of all multifamily buildings, they make up a much smaller portion of total multifamily units: only about one-third of multifamily rental units are in five- to forty-nine-unit buildings.<sup>21</sup>

Small rental properties tend to be significantly older than larger ones. Older properties tend to be in poorer condition and are thus typically more expensive to maintain, with the cost compounded by the fact that they typically house lower-income residents.<sup>22</sup> Of course, such tenants are less able to pay increased rent

16. THE STATE OF THE NATION'S HOUSING (2006), *supra* note 9, at 24.

17. THE STATE OF THE NATION'S HOUSING (2002), *supra* note 14, at 23; *see also* MALLACH, *supra* note 8, at 20 (noting that about three-fourths of owners of one- to four-family rental units work in a field unrelated to property ownership and only a handful of such owners earn all of their income from property ownership). A recent Joint Center paper argues for experimentation with ownership models for smaller properties as owners of such properties face a host of problems with them. *Revisiting Rental Housing Policy: Observations from a National Summit* 17 (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. W07-2, 2007), *available at* [http://www.jchs.harvard.edu/publications/rental/revisiting\\_rental\\_symposium/w07-2\\_revisiting\\_rental\\_policy\\_brief.pdf](http://www.jchs.harvard.edu/publications/rental/revisiting_rental_symposium/w07-2_revisiting_rental_policy_brief.pdf) [hereinafter *Revisiting Rental Housing Policy*].

18. THE STATE OF THE NATION'S HOUSING (2002), *supra* note 14, at 23 (using 1997 data).

19. For a brief history of the multifamily housing stock, *see* ADRIENNE SCHMITZ ET AL., MULTIFAMILY HOUSING DEVELOPMENT HANDBOOK 8-16 (2000).

20. CHRISTOPHER E. HERBERT, ABT ASSOCS. INC., AN ASSESSMENT OF THE AVAILABILITY AND COST OF FINANCING FOR SMALL MULTIFAMILY PROPERTIES 5 (2001), *available at* <http://www.huduser.org/Publications/pdf/smallmultifamily.pdf> (using data from HUD PROPERTY OWNERS AND MANAGERS SURVEY (1996), <http://www.huduser.org/DATASETS/poms.html>).

21. MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at 7.

22. *See* THE STATE OF THE NATION'S HOUSING (2002), *supra* note 14, at 22-23; Jack Goodman, *Determinants of Operating Costs of Multifamily Rental Housing* 20 (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. W04-7, 2004), *available at* <http://www.jchs.harvard.edu/publications/markets/w04-7.pdf> (estimating that utility costs are fifty-five percent less at properties built in 1990s than for similar properties built in 1970s); *see also* Ann B. Schnare, *The Impact of Changes in Multifamily Housing Finance on Older Urban Areas* 4 (Brookings Inst., Ctr. on Urban and Metro. Policy & Joint Ctr. for Hous. Studies of Harvard Univ., 2001), *available at* <http://>

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for improved maintenance. The units in this sector thus tend to be more affordable than units in larger buildings; this affordability is not surprising given their condition.<sup>23</sup> Small multifamily properties themselves are disproportionately located in communities with lower-income residents, higher poverty rates, and lower homeownership rates.<sup>24</sup> This combination of higher operating costs and lower rents makes smaller multifamily buildings a less attractive investment opportunity, all other things being equal.

The small multifamily subsector offers opportunities to burgeoning entrepreneurs but also carries great risks.<sup>25</sup> As the Joint Center has noted, many of these units are “owned by individuals with limited capacity to maintain and manage rental properties. Moreover, even the most sophisticated owners of smaller rental properties find it difficult to secure funds to maintain or upgrade their units.”<sup>26</sup>

As a result, “[f]or many of these landlords, the ventures are unprofitable: in 1995, thirty-two percent of owners with fewer than 10 units reported losses on their investments.”<sup>27</sup> Given all of this

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www.brookings.edu/es/urban/schnarefinal.pdf (noting that households living in the multifamily housing stock tend to be younger and poorer “than the average American household”). For a discussion of the characteristics of the middle market for rentals, see JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *MIDDLE MARKET RENTALS: HIDING IN PLAIN SIGHT* (2004), available at [http://www.jchs.harvard.edu/publications/markets/mmr04-1\\_middle\\_market\\_rentals.pdf](http://www.jchs.harvard.edu/publications/markets/mmr04-1_middle_market_rentals.pdf).

23. See THE STATE OF THE NATION’S HOUSING (2002), *supra* note 14, at 23; William Segal, *Segmentation in the Multifamily Mortgage Market: Evidence from the Residential Finance Survey*, 13 J. HOUSING RES. 175, 178 (2003). The Bureau of the Census’s 1991 Survey of Residential Finance found that rents in five- to forty-nine-unit properties were eighty-four percent of rents in larger properties. HERBERT, *supra* note 20, at 1.

24. Bogdon & Follain, *supra* note 9, at 114.

25. Owner-occupants of two- to four-unit buildings are more likely to be “urban, blue-collar, and less affluent than single-family homeowners.” See Mallach, *supra* note 8, at 21. They are also more likely to be people of color. *Id.*

26. THE STATE OF THE NATION’S HOUSING (2002), *supra* note 14, at 23.

27. THE STATE OF THE NATION’S HOUSING (2001), *supra* note 15, at 21; see also Amy S. Bogdon & David C. Ling, *The Effects of Property, Owner, Location and Tenant Characteristics on Multifamily Profitability*, 9 J. HOUSING RES. 285, 314 (1998) (a study of multifamily properties, finding that “[p]roperties held by nonprofits and corporations are less profitable, all else equal, than those held by other ownership structures”). Owner-occupiers, however, have fewer losses, with only fourteen percent of them reporting losses in 1995. *Id.* The Joint Center analysis does not appear to take into account the extent to which some investors purchase property with the express intent of incurring operating losses to offset current income and with the hope of future capital gains. See, e.g., HENRY J. AARON, *SHELTER AND SUBSIDIES* 66 (1972) (noting that major tax benefits available to owners of rental property is depreciation deduction in excess of actual decrease in fair market value); Kathy M. Kristof, *A Primer on Real Estate*

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bad news about owning rental units, it comes as no surprise that well over half of small nonresident owners would not have purchased their properties if they could do it all over again.<sup>28</sup> Notwithstanding this state of affairs, landlords of small rental properties also tend to hold them for a long time, although the speculation that was rampant in the early 2000s may have altered this pattern.<sup>29</sup>

While it is unlikely that many small-apartment-building owners purchase buildings in order to provide affordable housing to low- and moderate-income people, policymakers and affordable-housing advocates have identified such owners as key players in affordable-housing policy. Indeed, the Joint Center writes that the “fate of the affordable housing supply . . . relies critically on finding ways to assist these small property owners in preserving rental buildings.”<sup>30</sup> Because of fixed transaction costs, however, it is more expensive on a per-unit basis—thus much less common—to subsidize owners of smaller multifamily properties as opposed to owners of larger multifamily properties.<sup>31</sup> The Joint Center’s William Apgar and Shekar Narasimhan argue that because new production is directed at larger buildings, small multifamily buildings are “at risk of loss to disinvestment, demolition and abandonment.”<sup>32</sup>

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*Tax Breaks*, L.A. TIMES, July 8, 2002, at U9 (“[D]epreciation expenses frequently reflect phantom costs that can be used to shelter otherwise taxable income.”); *see also* ANTHONY DOWNS, RENTAL HOUSING IN THE 1980’S 48-49 (1983) (describing tax-advantaged status in the early 1980s of real-estate investments over alternate investments).

28. THE STATE OF THE NATION’S HOUSING (2002), *supra* note 14, at 23. One imagines that this figure has only increased during the Great Recession. R

29. *See* Mallach, *supra* note 8, at 22 (finding that the typical owner of one- to four-unit properties in 2001 has owned property for nine years); *see also* STERNLIEB & BURCHELL, *supra* note 7, at 55 (finding that nearly forty percent of buildings in a study of Newark “have been in the same hands for eleven or more years”). R

30. THE STATE OF THE NATION’S HOUSING (2007), *supra* note 12, at 22. This is an issue that disparately impacts communities of color. *Id.* In 2005, the minority share of renter households was forty-three percent and growing. *Id.* R

31. THE STATE OF THE NATION’S HOUSING (2002), *supra* note 14, at 23 (noting that “major supply-side housing assistance programs—including the Low-Income Housing Tax Credit—typically provide subsidies to larger properties, even though most renters needing assistance live in smaller properties”); Donald S. Bradley et al., *An Examination of Mortgage Debt Characteristics and Financial Risk Among Multifamily Properties*, 10 J. HOUSING. ECON. 482, 487 (2001) (noting that smaller properties “are also less likely to receive direct government assistance, including Section 8, the Low Income Housing Tax Credit, government grants and/or property tax relief” and that “[o]nly thirty-four percent of small properties reported that they receive some type of government assistance, compared to fifty-six percent of large developments”). R

32. Apgar & Narasimhan, *supra* note 1, at 3; *see also* Stegman, *supra* note 7, at 419 (“While national policy is committed to the goal of providing every American family with a decent home, one extremely scarce housing resource, the low-rent sector of R

## II. A BRIEF HISTORY OF SMALL MULTIFAMILY MORTGAGE FINANCE

Loan underwriting had historically been a very local activity, one that was based on a careful evaluation of an individual's financial prospects, reliability, and place within the community. Local thrifts, in particular, were very active in small multifamily lending, until the savings-and-loan crisis and the real-estate downturn of the 1980s reduced their activity in this area.<sup>33</sup> Since the 1980s, however, there has been a great change in multifamily property finance as the commercial mortgage-backed securities (CMBS) industry took off. This movement from local to global mortgage funding had a profound impact on the financing options available for small multifamily properties.

At the beginning of the twentieth century, entrepreneurs, particularly those who were different in some way (real or perceived) from their local bankers, faced great difficulty in obtaining financing from their local banks.<sup>34</sup> This difficulty was intensified in inner-city areas.<sup>35</sup> In the absence of financing from established lenders, more sympathetic savings and loans arose in established immigrant communities.<sup>36</sup> Borrowers also turned to informal lenders who would lend within a particular ethnic group.<sup>37</sup> These so-called "immigrant lenders" gave "many simple shopkeepers and small-scale entrepreneurs ready access to large pools of capital and . . . they

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the privately owned housing inventory, is being squandered."). Apgar and Narasimhan's point applies just as much to housing preservation efforts to the extent that they too focus on large projects.

33. See Denise DiPasquale & Jean L. Cummings, *Financing Multifamily Rental Housing: The Changing Role of Lenders and Investors*, 3 HOUSING POL'Y DEBATE 77, 78 (1992); James R. Follain & Edward J. Szymanoski, *A Framework for Evaluating Government's Evolving Role in Multifamily Mortgage Markets*, 1 CITYSCAPE: J. POL'Y DEV. & RES. 151, 151-52 (1995); see also Apgar & Narasimhan, *supra* note 1, at 7 ("Indeed, by 2001, S&Ls provided just 17.2 percent of financing to properties with 5 to 49 units, compared to 36.9 percent in 1991.").

34. Jared N. Day, *Credit, Capital and Community: Informal Banking in Immigrant Communities in the United States, 1880-1924*, 9 FIN. HIST. REV. 65, 65 (2002) (noting that immigrants were not usually welcomed at traditional banks); see also SAM B. WARNER, JR., *STREETCAR SUBURBS: THE PROCESS OF GROWTH IN BOSTON, 1870-1900*, at 117-24 (1961) (describing typically complex financing of residential projects in late nineteenth century).

35. See STERNLIEB, *supra* note 1, at 196.

36. DAVID L. MASON, *FROM BUILDINGS AND LOANS TO BAIL-OUTS: A HISTORY OF THE AMERICAN SAVINGS AND LOAN INDUSTRY, 1831-1995*, at 54-56 (2004).

37. Day, *supra* note 34, at 65. Indeed, Henry, Emmanuel, and Mayer Lehman began in the informal immigrant banking world before founding Lehman Brothers, as did A.P. Giannini, the founder of Bank of America. *Id.* at 77.

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overwhelmingly invested these funds in local real estate either as unlicensed lenders or as direct builders and purchasers.”<sup>38</sup> Because of the lack of access to traditional lenders, immigrant lenders became “critical sources of capital for local real estate investment.”<sup>39</sup>

Starting around World War I, the role of the immigrant lender in multifamily investment began to be displaced by competition from insurance and title companies, as well as other lenders.<sup>40</sup> And over the course of the Great Depression, with its concomitant wave of foreclosures, many landlords lost their buildings.<sup>41</sup> These trends initiated the professionalization of the multifamily real-estate industry, as many individual owners were shaken out, one way or another.<sup>42</sup> This trend continued in the Post-War period, accompanied by more and more government involvement in multifamily finance.<sup>43</sup>

Another significant ownership trend developed in the 1960s, whereby many African Americans purchased central-city, multifamily properties and used the housing for residential as well as income purposes.<sup>44</sup> This trend was accompanied by the widespread abandonment of central-city housing by many absentee owners in the 1960s and 1970s as buildings stopped producing sufficient in-

38. JARED N. DAY, *URBAN CASTLES* 40 (Kenneth T. Jackson ed., 1999). One 1920 federal report observed that “real estate, first and second mortgages, and speculative securities were favored forms of investment. Such holdings are almost uniformly the heaviest assets of the [immigrant] banker.” *Id.* at 40-41; see LOUIS WINNICK, *RENTAL HOUSING: OPPORTUNITIES FOR PRIVATE INVESTMENT* 159 (1958).

Frequently the small investor of past decades was a modest businessman or even a worker, often of foreign heritage, who regarded the purchase of a new residential property from his lifetime savings as providing not only a place to live, but also added personal status, a retirement income, and, with luck and rising prices, an estate for his children.

*Id.*; STEGMAN, *supra* note 8, at 41 (“Many of the smaller landlords are first-generation Americans . . .”).

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39. DAY, *supra* note 38, at 41 (“[E]vidence suggests that the overall volume of [immigrant lenders’] economic activity may have been staggering.”).

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40. *Id.* (noting that regulation drove out some immigrant lenders); see Donald S. Bradley et al., *Financing Multifamily Properties: A Play with New Actors and New Lines*, 4 CITYSCAPE: J. POL’Y DEV. & RES. 5, 11 (1998) (discussing the developing role of insurers and other new players in the multifamily mortgage market).

41. DAY, *supra* note 38, at 176-177.

42. *Id.* Louis Winnick noted that one estimate in the 1950s found that “the proportion of apartment mortgage debt held by institutional lenders rose from about 50 [percent] at the end of the twenties to 80 [percent] in the mid-fifties.” WINNICK, *supra* note 38, at 160.

43. See MORTON, *supra* note 10, at 48-70 (providing detailed history of growth and structure of lending industry through early 1950s); WINNICK, *supra* note 38, at 155.

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44. STERNLIEB & BURCHELL, *supra* note 7, at 97.

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come even to cover the basic costs of taxes and utilities, let alone insurance, financing, and maintenance expenses.<sup>45</sup> As many cities became unstable in the 1960s, private lenders became scarce in the multifamily market.<sup>46</sup> Even after cities recovered from the abandonment crisis, the multifamily market continued with a cycle of booms and busts—most notably the late-1980s to early-1990s bust and the late-1990s and early-2000s boom—followed by the bust in which we now find ourselves.<sup>47</sup>

Historically, the available private-sector lending was unattractive from the multi-unit landlord's perspective.<sup>48</sup> Throughout much of the twentieth century, private multifamily mortgages had been short term, requiring a borrower to refinance frequently and face the risk that the interest-rate environment might become unfavorable.<sup>49</sup> Such an unstable lending environment can lead to a depressed real-estate market as owners lose faith in their ability to sell

45. See, e.g., STERNLIEB & BURCHELL, *supra* note 7, at 269-352 (studying abandonment in Newark); THE NEW YORK CITY RAND INSTITUTE, RENTAL HOUSING IN NEW YORK CITY 9-11 (Ira S. Lowry ed., 1970) [hereinafter RENTAL HOUSING IN NEW YORK CITY]; David J. Reiss, *Housing Abandonment and New York City's Response*, 22 N.Y.U. REV. L. & SOC. CHANGE 783 (1996). The abandonment crisis was most severe in the East, as broad demographic changes drove jobs and people to other parts of the country. See Harold L. Bunce & Sue G. Neal, *Trends in City Conditions During the 1970s: A Survey of Demographic and Socioeconomic Changes*, 14 PUBLIUS 7, 8-10 (1984).

46. See, e.g., STEGMAN, *supra* note 8, at 197 ("In Baltimore, too, the absence of mortgage capital is a critical factor in the declining inner-city market . . ."); STERNLIEB & BURCHELL, *supra* note 7, at xxv ("Primary lenders in urban areas—commercial and mutual savings banks, savings and loan associations, insurance companies, and even individuals—are getting out of the inner city mortgage lending business. They are replaced by mortgage companies which deal almost exclusively in insured loans."); see also RENTAL HOUSING IN NEW YORK CITY, *supra* note 45, at 9 ("[I]nstitutional investors are, as rapidly as possible, reducing their portfolios of controlled housing and of housing in deteriorated neighborhoods.").

47. Lawrence Goldberg & Charles A. Capone, Jr., *Multifamily Mortgage Credit Risk: Lessons from Recent History*, 4 CITYSCAPE: J. POL'Y DEV. & RES. 93, 95 (1998) (discussing tax and accounting aspects of booms and busts of 1980s-2000s); Segal, *supra* note 23, at 178 (discussing the 1980s and 1990s bust); Prabha Natarajan, *Real-Estate Finance: Apartments Try to Stay Afloat*, WALL ST. J., Jan. 14, 2009, at C11 (reporting on rising mortgage defaults for multifamily properties).

48. See STERNLIEB & BURCHELL, *supra* note 7, at 237. The authors note, The availability of institutional financing is one of the major determinants of the health and vitality of the real estate market. If the banks, savings and loan companies, insurance companies, and the like are willing to lend in an area, then owners can have confidence that their investments in properties are redeemable through ultimate resale or remortgaging.

*Id.*

49. GEORGE STERNLIEB & JAMES W. HUGHES, THE FUTURE OF RENTAL HOUSING 89 (1981).

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their property because potential buyers are unable to arrange for financing.<sup>50</sup>

Owners of smaller multifamily properties seem to find their financing options even less attractive, as seen from the fact that such buildings are mortgaged less often than larger multifamily properties.<sup>51</sup> Mortgages secured by smaller properties also tend to have higher interest rates,<sup>52</sup> and they have adjustable interest rates more frequently than mortgages secured by larger properties; this exposes them to interest-rate risk.<sup>53</sup>

One major reason for the different mortgage terms for small and large properties is that the underwriting of any commercial mortgage is associated with significant fixed costs.<sup>54</sup> These underwriting costs, payable to third-party providers, can exceed \$10,000

50. *Id.* at 87-89.

51. Segal, *supra* note 23, at 179-80 (noting that owners of smaller buildings are more likely to rely on relational financing from depository institutions). The lower rate of mortgages for smaller buildings may also be explained in part by the fact that smaller buildings are easier to buy in an all-cash transaction and that smaller mortgages can be paid in full more easily. Finally, it is unclear what the socially optimal rate of financing for multifamily buildings is, so it may or may not be that the lower proportion of mortgages for smaller buildings is actually undesirable. That being said, many of the commentators discussed herein take the position that the small multifamily sector has a more difficult time obtaining financing than other sectors of the mortgage market.

52. HERBERT, *supra* note 20, at 13. Small multifamily properties also tend to pay significantly higher mortgage rates. Bradley, *supra* note 31, at 502 (estimating that rates on small properties are about 100 basis points higher than rates on large developments); see also Drew Schneider & James Follain, *A New Initiative in the Federal Housing Administration's Office of Multifamily Housing Programs: An Assessment of Small Projects Processing*, 4 CITYSCAPE: J. POL'Y DEV. & RES. 43, 49 (1998) (noting that, in some cases, smaller multifamily mortgages are as much as 300 basis points higher).

53. HERBERT, *supra* note 20, at 13-14. Interest-rate risk is the risk that the payments a company owes on short-term debt that funds purchases become mismatched with the interest payments it receives in turn from its long-term investments. David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae & Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019, 1031 (2008).

54. Schneider & Follain, *supra* note 52, at 49-50; see also HERBERT, *supra* note 20, at iv (arguing that higher interest rates reflect the need to amortize fixed costs over the life of the loan, the reduced competition in the market segment, and the lack of sophistication of the borrowers in that segment). Commercial mortgage underwriting primarily focuses on the ability of the property to cover its monthly expenses and its monthly mortgage expenses in particular. By way of contrast, residential mortgage underwriting focuses on whether the borrower has the capacity to repay the loan.

A recent study of community bank underwriting suggests that the use of consumer credit scores for owners of small businesses—as opposed to reliance on best estimates of the creditworthiness of the small business itself—may prove a way to expand credit without increasing credit risk. See Allen N. Berger et al., *The Surprising Use of Credit Scoring in Small Business Lending by Community Banks and the Attendant Effects on Credit Availability and Risk* 1-4 (Fed. Reserve Bank of Atlanta, Working Paper 2009-9, 2009), available at <http://www.frbatlanta.org/filelegacydocs/wp0909.pdf>.

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and typically include charges for appraisals, environmental reviews, and attorney certifications.<sup>55</sup> Because the small-apartment-building lender has to recoup those costs from a smaller principal base, there will be higher upfront fees or a higher interest rate, which will allow the lender to amortize those fixed costs over time.<sup>56</sup>

As a result of the unattractive terms available in the private, multifamily mortgage market generally, the government sector has sought to expand financing options.<sup>57</sup> Various government programs stepped in to provide more stable lending to such borrowers, including the Federal Housing Administration (FHA), as well as state- and government-sponsored enterprise programs.<sup>58</sup> Because of the high fixed costs associated with originating and servicing such loans, however, these government programs faced similar constraints as private lenders. As a result, these multifamily mortgage programs also have historically poorly served the smaller multifamily subsector.

A variety of FHA programs provided mortgages, either directly or indirectly, for multifamily properties.<sup>59</sup> The market penetration of these programs has waxed and waned with changes in the market and the political environment.<sup>60</sup> FHA programs, however, have been frequently criticized for their high interest rates, slow approval processes, overly strict underwriting criteria, and relatively short (five-year) terms.<sup>61</sup> Over time, the FHA has also

55. See HERBERT, *supra* note 20, at 15-16.

56. See Bradley et al., *supra* note 40, at 15 (noting that the fixed costs of loan review “increase as a percentage of loan balance as loan size decreases”).

57. See STERNLIEB & HUGHES, *supra* note 49, at 91 (noting that the government sector had become a dominant lender in the multifamily sector even though it imposes some terms that landlords find onerous).

58. See *id.* at 89-91.

59. The FHA provides for mortgages indirectly by offering mortgage insurance to lenders that insures against losses incurred when borrowers default. ALEX F. SCHWARTZ, HOUSING POLICY IN THE UNITED STATES 49-50 (2006) (discussing various FHA programs); EDWARD J. SZYMANOSKI & SUSAN J. DONAHUE, DO FHA MULTIFAMILY MORTGAGE INSURANCE PROGRAMS PROVIDE AFFORDABLE HOUSING AND SERVE UNDERSERVED AREAS? 6 (1999); U.S. Dep’t of Hous. & Urban Dev., Descriptions of Multifamily Programs, <http://www.hud.gov/offices/hsg/mfh/progdesc/progdesc.cfm> (last visited Apr. 3, 2010) (listing FHA mortgage insurance origination programs).

60. Vandell, *supra* note 10, at 323 (noting that “[b]y 1993, FHA was virtually out of the multifamily business, making up only 6 percent of multifamily starts”).

61. See, e.g., STERNLIEB, *supra* note 1, at 186-87, 192-96; WINNICK, *supra* note 38, at 171; Follain & Szymanoski, *supra* note 33, at 152-53 (discussing the “litany of problems” with the FHA). The FHA responds to these criticisms on its website. FHA Website, Dispelling Common Myths About Participating with FHA (on file with author). For a history of the early FHA, seen from a planning perspective, see MARK A.

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tended to provide financing for larger buildings as well, in part because of the efficiencies presented by larger projects.<sup>62</sup> This was compounded by the fact that owners of smaller properties were often less likely to know about and access such government programs because of lack of knowledge about, experience with, and expertise with them.<sup>63</sup>

Many states have housing finance agencies that provide low-interest loans and long terms in exchange for caps on rents.<sup>64</sup> However, these programs also tend to favor larger projects, because, again, of the fixed costs associated with them.<sup>65</sup> Other state-government programs directed at property owners are also less often accessed by owners of smaller multifamily properties.<sup>66</sup>

The federal government has not taken a strong lead in supporting small multifamily finance as compared to other mortgage sub-sectors.<sup>67</sup> The Federal National Mortgage Association (commonly known as “Fannie Mae”) and the Federal Home Loan Mortgage Corporation (commonly known as “Freddie Mac”), the two government-sponsored enterprises that dominate the conforming residential (owner-occupied) mortgage-backed securities (RMBS) market, first entered the multifamily market in a significant way in the

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WEISS, *THE RISE OF THE COMMUNITY BUILDERS: THE AMERICAN REAL ESTATE INDUSTRY AND URBAN LAND PLANNING* 141-158 (1987).

62. See STERNLIEB, *supra* note 1, at 189 (noting that fixed costs could be spread over more units in larger buildings); Segal, *supra* note 23, at 189 (noting that the proportion of small-multifamily mortgages insured by the FHA fell from 39.4% in 1989 to 1.9% in 2002). In 1997, the FHA announced its Small Projects Processing Program, which was intended to reach the small-project market that had been marginalized in earlier FHA programs. *Id.*; see also Schneider & Follain, *supra* note 52, at 48 (finding that the FHA’s standard multifamily programs “are prohibitive for financing small projects”). Vandell does note, however, that the FHA has focused on smaller projects at various times in its history. Vandell, *supra* note 10, at 324 (noting that FHA’s post-war focus was on smaller projects).

63. See STERNLIEB, *supra* note 1, at 189.

64. See National Council of State Housing Agencies, HFA Directory, <http://www.ncsha.org/housing-help> (last visited Apr. 27, 2010).

65. Schnare, *supra* note 22, at 21-22 (citing Bradley, *supra* note 31); see also JUSTIN COOPER, *MULTIFAMILY RENTAL HOUSING: FINANCING WITH TAX-EXEMPT BONDS* 21 (2003) (noting that because the costs of offering tax-exempt bonds “to the public are largely fixed, but project sizes and costs vary widely, some transactions are too small to justify the cost of a public offering”).

66. Bradley, *supra* note 31, at 487.

67. See MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at iv. For a list of federal multifamily finance programs, see SCHMITZ ET AL., *supra* note 19, at 160. In a 1992 study prepared for HUD, researchers found that ten percent of all units in HUD-insured multifamily housing properties were in buildings with fewer than fifty units. JAMES E. WALLACE ET AL., *ASSESSMENT OF THE HUD-INSURED MULTIFAMILY HOUSING STOCK* 2-4 (1992).

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1990s.<sup>68</sup> Fannie Mae and Freddie Mac have, however, had limited exposure to the small multifamily sector, tending to put their resources in the large multifamily sector.<sup>69</sup> This is partly because their underwriting and servicing standards often are uneconomical or too stringent for smaller buildings and their owners.<sup>70</sup>

Starting in the early 1990s, a vibrant, private, secondary mortgage market for multifamily housing mortgages also developed.<sup>71</sup> At that time, the Wall Street firms developed so-called “private-label” CMBS which included multifamily mortgages.<sup>72</sup> At the peak of the global CMBS market in 2007, there was nearly \$309 billion in CMBS issued, of which almost \$49 billion, or sixteen percent, was comprised of multifamily mortgages.<sup>73</sup>

68. See generally DiPasquale & Cummings, *supra* note 33.

69. MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at 4; see also Frank E. Nothaft & James L. Freund, *The Evolution of Securitization in Multifamily Mortgage Markets and Its Effect on Lending Rates*, 25 J. REAL EST. RES. 91, 91-92 (2003) (describing Fannie Mae and Freddie Mac’s limited exposure to multifamily sectors, which “reflected the nature of the underlying multifamily loans: mortgage contracts were not standardized, the collateral rental properties were heterogeneous and the geographic concentration of properties made multifamily lending a more risky undertaking”). As the Joint Center notes, Fannie and Freddie typically “only increased their focus on financing smaller (5-49 unit) multifamily rental properties temporarily when” doing so helped them meet the affordable housing goals set for them by Congress. MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at 7; see KIMBERLY BURNETT & LINDA B. FOSBURG, *STUDY OF THE MULTIFAMILY UNDERWRITING AND THE GSEs’ ROLE IN THE MULTIFAMILY MARKET: EXPANDED VERSION*, at x-xi (2001) (noting that the “GSEs’ multifamily purchases do not appear to be contributing consistently to the mitigation of excessive cost of mortgage financing facing small properties with five to 50 units,” but also noting that HUD had implemented an incentive for the GSEs to become more active in this segment); see also HUD’s Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), 65 Fed. Reg. 65,044, 65,045 (Oct. 31, 2000) (codified at 24 C.F.R. pt. 81 (2009)) (noting that Fannie Mae and Freddie Mac “have been much less active in purchasing mortgages in markets where there is a need for additional financing to address persistent housing needs including financing for small multifamily rental properties, manufactured housing, single family owner-occupied rental properties, seasoned affordable housing mortgages, and older housing in need of rehabilitation”).

70. Schneider & Follain, *supra* note 52, at 49.

71. See AMERICA’S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY, *supra* note 3, at 14; DiPasquale & Cummings, *supra* note 33.

72. Kent W. Colton & Kate Collignon, *Multifamily Rental Housing in the 21st Century* 64 (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. W01-1, 2001), available at [http://www.jchs.harvard.edu/publications/finance/colton\\_w01-1.pdf](http://www.jchs.harvard.edu/publications/finance/colton_w01-1.pdf).

73. COMMERCIAL MORTGAGE ALERT, GLOBAL CMBS ISSUANCE IN 2008 (2008), available at <http://www.cmalert.com/ranking.php?rid=198>. Global Multifamily CMBS issuance grew from \$9.9 billion in 2000. COMMERCIAL MORTGAGE ALERT, GLOBAL CMBS ISSUANCE IN 2001 (2001), available at <http://www.cmalert.com/ranking.php?rid>

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Securitization works best when the underlying assets are similar because such similarity reduces due diligence and other costs.<sup>74</sup> One of the main limitations of the multifamily CMBS market is that the underlying mortgages are not uniform, particularly in the case of smaller properties.<sup>75</sup> This increases the transaction costs for all parties who must deal with them.<sup>76</sup> Furthermore, owners of small properties often do not keep the kind of records that investors would require in order to invest in such properties, even at the mortgage-backed pool level.<sup>77</sup>

The proportion of multifamily mortgages that had been securitized since the early 1990s has grown steadily as Fannie Mae and Freddie Mac and the private-label sector has gained more experience with the CMBS market.<sup>78</sup> In 1986, less than ten percent of multifamily mortgages were either held or securitized through the activities of government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac, federal agencies like Ginnie Mae, and private securities issuers.<sup>79</sup> Just ten years later, in 1996, this number had jumped to twenty-three percent.<sup>80</sup> And in 2006, prior to the

=170. It has since fallen to \$2.9 billion in 2008 as a result of the credit crisis. See GLOBAL CMBS ISSUANCE IN 2008, *supra*.

74. See Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765, 778 (2005) (“Without a standardized mortgage document and uniform lending techniques, the secondary market never would have gotten off the ground.”).

75. THE STATE OF THE NATION’S HOUSING (2002), *supra* note 14, at 23; DiPasquale & Cummings, *supra* note 33, at 97.

76. DiPasquale & Cummings, *supra* note 33, at 97.

77. Apgar & Narasimhan, *supra* note 1, at 2.

78. AMERICA’S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY, *supra* note 3, at 14 (“Along with increased standardization of underwriting criteria and loan documentation, these trends created a larger, more stable, and less expensive source of capital for rental property owners and developers, while also providing greater diversification for investors.”).

79. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1985-1994, at 87 tbl.L.219 [hereinafter FLOW OF FUNDS 1985-1994], available at <http://www.federalreserve.gov/releases/z1/Current/annuals/a1985-1994.pdf>. The calculations in this paragraph take into account the sum of outstanding multifamily residential mortgage debt attributed to “Government-sponsored enterprises,” “Agency- and GSE-backed mortgage pools,” and “ABS issuers,” as compared to the “Total Liabilities” of multifamily residential mortgage debt.

80. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1995-2004, at 87 tbl.L.219, available at <http://www.federalreserve.gov/releases/z1/Current/annuals/a1995-2004.pdf>.

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credit crisis, roughly forty-five percent of multifamily mortgages were sold into the secondary mortgage market.<sup>81</sup>

However, the increase in securitization was concentrated in mortgages secured by large properties.<sup>82</sup> Small multifamily mortgages made up significantly less than ten percent of total securitized multifamily volume in the late 1990s and early 2000s.<sup>83</sup> Smaller loans and loans for properties with five to forty-nine units mostly bypass the secondary market altogether and remain in the domain of bank and thrift portfolio lenders.<sup>84</sup>

81. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 2005-2008, at 87 tbls.L.218 & L.219 [hereinafter FLOW OF FUNDS 2005-2008], available at <http://www.federalreserve.gov/releases/z1/Current/annuals/a2005-2008.pdf>. By way of contrast, sixty percent of mortgages on one- to four-family properties were sold into the secondary mortgage market in 2006. *Id.* This increase in securitization was, of course, at the expense of traditional players in the commercial mortgage market: the portion of multifamily mortgages held by commercial banks, savings institutions, and life insurance companies dropped from sixty-two percent in 1986, FLOW OF FUNDS 1985-1994, *supra* note 79, at 87 tbl.L.219, to forty percent in 2006, FLOW OF FUNDS 2005-2008, *supra*, at 87 tbl.L.219.

82. AMERICA'S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY, *supra* note 3, at 14. The report notes,

[A] dual mortgage delivery system began to emerge. Individuals and investors seeking to purchase, rehabilitate, or build smaller rental properties were increasingly served by a distinctly different set of mortgage products, provided by a distinctly different set of lenders, than those financing larger rental properties. The Survey of Residential Finance documents [show] that by 2001, some 86 percent of all apartment properties with 50 or more units had a mortgage, and as many as 65 percent of these properties had a level-payment, fixed-rate loan. In contrast, only 58 percent of five- to nine-unit apartment buildings had a mortgage, and just a third had level-payment, fixed-rate mortgages.

*Id.*

83. Segal, *supra* note 23, at 191. Christopher Herbert, writing in 2001, noted that only 1.8% of loans in CMBS consisted of small loans. HERBERT, *supra* note 20, at 14. Herbert's research suggests that the CMBS market does not offer lower interest rates; rather, it offers fixed-rate financing where depositories typically offer adjustable-rate financing. *Id.* at vi. Even though Fannie and Freddie's exposure to this submarket is small, it is larger than that of private label CMBS players. *Id.* at vii. Other actors play a significant role in financing multifamily housing: for instance, pension funds and life insurance companies typically finance luxury multifamily developments. MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at 4. Mortgage Real Estate Investment Trusts also invest in multifamily projects. SCHMITZ, MULTIFAMILY HOUSING DEVELOPMENT HANDBOOK, *supra* note 19, at 156; see Vandell, *supra* note 10, at 345 (discussing limited role of mortgage REITs in multifamily finance). I have not been able to find more up-to-date data for small multifamily securitization rates.

84. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 24 (2004) [hereinafter THE STATE OF THE NATION'S HOUSING (2004)], available at <http://www.jchs.harvard.edu/publications/markets/son2004.pdf> (noting that in 1999, "more than half of all multifamily loans financed by banks and thrifts had

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In sum, the small multifamily subsector remains comparatively underserved in the secondary mortgage market as well as in the primary mortgage market.<sup>85</sup> As a result, there is evidence that a “credit gap” has existed in parts of the multifamily mortgage market, particularly in the five- to forty-nine-unit property sector.<sup>86</sup> The question remains: should the government intervene to shrink that gap?

### III. THE CASE FOR SUBSIDIZING LANDLORDS OF SMALL PROPERTIES HAS NOT BEEN MADE

As leading housing scholar Stegman notes, “it is obvious that the substantial owner of slum real estate is not in business for altruistic purposes’ . . . but since when is altruism a prerequisite for progress?”<sup>87</sup> Stegman and Sternlieb argue that it may benefit society to help wealth-maximizing small-apartment-building owners in order to ultimately assist low- and moderate-income tenants.<sup>88</sup>

While I do not disagree with this general proposition, I believe that we should be certain that any aid given to landlords will actually be passed on in large part to their tenants, whether through lower rents or improved conditions. As such, I question the extent to which the government should implement affordable housing initiatives by subsidizing small-apartment-building owners. This question is of pressing importance because leading housing scholars

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balances of \$1 million or less, compared with about 15 percent of the multifamily loans financed by” Fannie Mae and Freddie Mac). HUD’s 1996 Property Owners and Managers Survey reveals that depositories fund about seventy percent of mortgages for buildings with fewer than fifty units versus forty-five percent of properties with one hundred or more units. Herbert, *supra* note 20, at 13; *see also* THE STATE OF THE NATION’S HOUSING (2004), *supra*, at 24 (noting that because of the history of the secondary mortgage market, two- to four-unit properties are more readily securitized because they are grouped with single-family homes in the residential mortgage market and are securitized as part of residential, mortgage-backed securities). Although underwriting costs for small properties are proportionately higher, it appears that such properties are “comparable to larger multifamily properties in historical loan performance.” Schneider & Follain, *supra* note 52, at 49.

85. See HUD’s Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), 65 Fed. Reg. 65,044, 65,050 (Oct. 31, 2000) (codified at 24 C.F.R. pt. 81) (“There is evidence that the aging stocks of single family rental properties and small multifamily properties with 5-50 units, which play a key role in lower-income housing, have experienced difficulties in obtaining financing.”).

86. William Segal & Edward J. Szymanoski, *Fannie Mae, Freddie Mac, and the Multifamily Mortgage Market*, 4 CITYSCAPE: J. POL’Y DEV. & RES. 59, 65 (1998).

87. Stegman, *supra* note 7, at 423 (quoting STERNLIEB, *supra* note 1, at 139).

88. See generally STERNLIEB, *supra* note 1; Stegman, *supra* note 7.

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believe that small multifamily mortgages should in fact be subsidized.

Leading housing scholars have advocated for small multifamily mortgage subsidies for over forty years. Michael Stegman has called for decreased costs for small-property owners, even while acknowledging that there “is something distasteful about trying to rally support for a group of property owners who have been considered the natural enemy of liberal housing reformers ever since the industrial revolution.”<sup>89</sup> More recently, the Joint Center, along with affiliated researchers, has called for Congress to expend public funds to develop new financing tools, including subsidies, for small, privately-owned apartment buildings.<sup>90</sup>

The Joint Center’s William Apgar and Shekar Narasimhan have presented perhaps the most well-developed subsidy proposal to date.<sup>91</sup> They advocate that the federal government sponsor a “small Real Estate Investment Trust (S-REIT) that would aggregate ownership of older, smaller multifamily properties with low or

89. Stegman, *supra* note 7, at 420.

90. See, e.g., AMERICA’S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY, *supra* note 3, at 20. For example,

Since developing new affordable rental housing remains difficult without steep subsidy, preserving whatever low-cost units remain should be an urgent priority. The success of preservation efforts depends in large measure on the willingness of Congress to appropriate sufficient funds to renew expiring project-based contracts and fund additional efforts to slow the loss of privately owned low-cost rentals.

*Id.*; see William Apgar, *Rethinking Rental Housing: Expanding the Ability of Rental Housing to Serve as a Pathway to Economic and Social Opportunity* 55 (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. W04-11, 2004), available at <http://www.jchs.harvard.edu/publications/markets/w04-11.pdf> (fleshing out a proposal for a trust that “could combine private capital with federal, state and local resources, while at the same time reducing costs associated with obtaining subsidies on a project-by-project basis”); *Revisiting Rental Housing Policy*, *supra* note 17, at 16 (“Some owners who are interested in continuing to operate their properties as low-cost housing will need help with capital needs; other properties may need to be purchased to preserve affordability. While much is known about ways to preserve subsidized developments, preservation strategies for the unassisted stock have received little attention”); Stegman, *supra* note 7, at 420. Shaun Donovan, now the Secretary of HUD, has proposed subsidizing the cost of underwriting, servicing, and securitization for small multifamily buildings. Shaun Donovan, Background Paper on Market Rate Multifamily Rental Housing 21 (Millennial Hous. Comm’n, Fin. Task Force, 2002), <http://govinfo.library.unt.edu/mhc/papers/mrmf.doc>. This proposal rests, it appears, on the assumption that such a subsidy would be a relatively efficient way to increase the supply of affordable housing. See Stegman, *supra* note 7, at 420.

91. Despite the repeated refrain for new financing alternatives and subsidies by affordable-housing advocates like the Joint Center, there is surprisingly little in concrete proposals as to how to implement policies directing subsidies to small-building owners.

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modest rents” and act as a conduit for federal subsidies.<sup>92</sup> From this investment vehicle, small-multifamily-property owners would receive the following benefits: they would incur no capital gains tax on exchanging their property for a proportionate (and liquid) interest in the S-REIT; they would gain access to credit at a lower price by means of the S-REIT’s tax-exempt bond issuing capability; and properties managed by the trust would be exempt from recording taxes and would be eligible for local tax abatements.<sup>93</sup> Individually, each of these benefits would confer a significant advantage over owners of comparable properties; taken collectively, these benefits represent a substantial subsidy channeled directly to owners of small multifamily buildings who choose to participate in an S-REIT.

There are two main rationales for subsidizing small-building landlords. First, they provide housing to the neediest tenants: low- and moderate-income families who are not fortunate enough to have obtained subsidized apartments. Second, the multifamily mortgage market is subject to market failures that make government intervention appropriate. I will assess these two rationales in turn.

#### A. *The Affordability Rationale*

Housing economist John Quigley writes,

“Affordability” is clearly the most compelling rationale for polices [sic] subsidizing rental housing. The high cost of rental housing, relative to the ability of low-income households to pay for housing, means that these households have few resources left over for expenditures on other goods—food, clothing, medicine—which are also necessities.<sup>94</sup>

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92. Apgar & Narasimhan, *supra* note 1, at 2. The Community Preservation Corporation (CPC) also proposed a model of MBS that was intended to address the needs of smaller (six to twelve) unit buildings. Follain & Szymanoski, *supra* note 33, at 168-72 (evaluating the CPC proposal).

93. Apgar & Narasimhan, *supra* note 1, at 19-20.

94. John M. Quigley, Just Suppose: Housing Subsidies for Low-Income Renters 13 (Joint Ctr. for Hous. Studies of Harvard Univ., Paper No. RR07-9, 2007), *available at* [http://www.jchs.harvard.edu/publications/rental/revisiting\\_rental\\_symposium/papers/rr07-9\\_quigley.pdf](http://www.jchs.harvard.edu/publications/rental/revisiting_rental_symposium/papers/rr07-9_quigley.pdf), and reprinted in REVISITING RENTAL HOUSING: POLICIES, PROGRAMS, AND PRIORITIES 300 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008); see Robert C. Ellickson, The Mediocrity of Government Subsidies to Mixed-Income Housing Projects 3 (Yale Law Sch., John M. Olin Ctr. for Studies in Law, Economics, and Public Policy, Paper No. 360, 2008), *available at* <http://ssrn.com/abstract=1217870> (“Most housing experts agree that the chief challenge today is not how to improve the quality of American dwellings, but how to make what’s available more affordable to households on a tight budget.”); Schnare, *supra* note 22, at 27 (“Given the relatively low incomes of

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Quigley's position applies to all affordable housing subsidies. To make the case that it applies with special force to subsidies directed at for-profit owners of small apartment buildings, one must argue that such actors are better at delivering affordable housing to at least some category of households than other actors.

And, indeed, that argument does have some merit. For instance, if other providers of affordable housing systematically exclude some low-income households, a case may be made that for-profit owners of small apartment buildings do play a socially beneficial role as landlords of last resort. There is evidence that some affordable housing providers have a history of behaving in just this way. Public housing authorities have at various times in their history effectively screened "out any prospective tenant family who for any reason might act irresponsibly or fail to adequately care for its government-owned housing unit."<sup>95</sup> Michael Stegman therefore argues that it "rests with the private landlord to provide such families with housing."<sup>96</sup> While Stegman wrote this over forty

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this nation's renters—and the relatively high costs of operating and maintaining units—there is a real and unmet need for rental subsidies."); see also Roger Starr, *Private Ventures in Slum Building Rehabilitation for Low-Income Families*, 24 J. HOUSING 32 (1967). Starr notes that

it is clear that rehabilitation of old law tenements for low income families cannot be done profitably without heavy subsidization—above and beyond low interest, long term mortgages, and tax abatements. What seems to be needed are either rent supplements, which would permit realistic rent levels, or an initial capital grant which would help keep rents at a level that tenants could afford out of their own earnings.

*Id.*, quoted in Stegman, *supra* note 7, at 423; WINNICK, *supra* note 38, at 171 ("The problems and perplexities of rental housing demonstrate that some form of government assistance has been—and still is—an inescapable requirement for an adequate volume of new private investment in rental housing . . .").

95. Stegman, *supra* note 7, at 420; SCHWARTZ, *supra* note 59, at 105 (noting that during the early days of public housing, "[m]anagers conducted home visits to most applicants to see whether their households were sufficiently orderly to qualify for public housing," and that "[m]anagers were also not shy about evicting unruly tenants or tenants who failed to keep their homes up to an acceptable standard of tidiness"); Michael H. Schill & Susan W. Wachter, *The Spatial Bias of Federal Housing Law and Policy: Concentrated Poverty in Urban America*, 143 U. PA. L. REV. 1285, 1298 (1995) ("In the early years of the [public housing] program, [Public Housing Authorities] had enormous latitude in admission and eviction decisions. This freedom permitted [the housing authorities] to screen out 'problem' tenants and quickly evict those who created difficulties."); see also NICHOLAS DAGEN BLOOM, *PUBLIC HOUSING THAT WORKED: NEW YORK IN THE TWENTIETH CENTURY* 7 (2009) (noting that the level of scrutiny applied to public-housing applicants waxed and waned over time and among jurisdictions).

96. Stegman, *supra* note 7, at 420.

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years ago, his argument can hold true for federally assisted housing providers today.<sup>97</sup>

This state of affairs is further exacerbated by the long-term disinvestment in the nation's stock of subsidized affordable housing. Since the 1980s,

the pace of government spending in general has slowed; the problems in large-scale public housing projects are proving intractable; the new subsidized alternative—small-scale, scattered-site, mixed-income projects—provides housing for very few families at an exorbitant cost. It has become apparent to most that the government simply cannot replace the private sector in the housing market. The regulatory environment needs to reflect this new policy awareness and encourage, or at least not discourage, private rental housing ownership.<sup>98</sup>

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97. "Federally assisted housing" includes public-housing projects, Section-8 tenant-based rent vouchers, as well as housing financed, insured, constructed, and substantially rehabilitated via federal funding. 42 U.S.C. § 13641(2) (2006). By statute, providers of federally assisted housing are required to screen prospective tenants and may reject households where any member is using illegal drugs, abusing alcohol, or is engaging in any "criminal activity which would adversely affect the health, safety, or right to peaceful enjoyment of the premises by other residents." 42 U.S.C. § 13661; *see also* 24 C.F.R. § 960.203 (2009). Similarly, federal law provides for the termination of assistance where a household member is found to be using drugs or abusing alcohol. 42 U.S.C. § 13662. In both screening and termination decisions, what constitutes a disqualifying violation is left to the discretion of the housing provider. *Id.* This blanket authority has prompted one public-interest lawyer to warn that the greatest concern for advocates representing poor clients is "overzealous officials" barring families with even minor criminal histories, despite the absence of a conviction or even an arrest. John J. Ammann, *Housing out the Poor*, 19 ST. LOUIS U. PUB. L. REV. 309, 318 (2000). Further, the aggressive implementation of such "One Strike" policies to disqualify federal housing applicants has been incentivized by HUD. Funding bonuses and freedom from federal oversight is linked, in part, to the number of applicants a housing authority has rejected in accordance with the "One Strike" initiative. *See* 24 C.F.R. § 902.71 (laying out incentives for housing authorities); OFFICE OF PUB. & INDIAN HOUS., U.S. DEP'T OF HOUS. & URB. DEV., "ONE STRIKE AND YOU'RE OUT" POLICY IN PUBLIC HOUSING (attachment to Notice No. 96-16, Apr. 12, 1996), *available at* <http://www.hud.gov/offices/adm/hudclips/notices/pih/files/96-16PIHN.doc> (exhorting housing authorities to aggressively implement "One Strike" criteria in return for performance incentives).

Compounding the difficulties faced by tenants of federally assisted housing, existing law also empowers housing providers to disqualify entire households for the acts of a single member, even where the family is ignorant of the offending conduct. 42 U.S.C. § 1437d(l)(6); *see* HUD v. Rucker, 535 U.S. 125, 136 (2002) (affirming a public-housing operator's broad authority to conduct such "no-fault" evictions under the statute).

98. Schloming & Schloming, *supra* note 12, at 30; *see* RICHARD HILTON & CHARLES HANSON, EVALUATION OF THE MARK-TO-MARKET PROGRAM 1 (2004) (noting that from the mid-1960s through the mid-1980s "the Federal Government committed substantial resources for project-based rental assistance in new or substantially rehabilitated multifamily (5 units or more) properties for low- or moderate-income

A final important factor contributing to the problem of affordability is that a significant amount of rental housing is being demolished or permanently taken out of service; this is particularly true in distressed communities where the need for affordable housing is often the greatest, but rings true in gentrifying communities as well.<sup>99</sup>

With possible “skimming” of the best tenants by government and not-for-profit housing providers, the long-term reduction in government-supported housing, and the material reduction in the stock of affordable housing, low- and moderate-income families who did not get a subsidized apartment have to fend for themselves in the private housing market. As a result of these long-term trends, the Joint Center has sought to redirect some of the focus of the housing preservation debate from subsidized housing to “the

families,” and that “[t]hese properties were subsidized through a variety of different programs, but they were all provided with long-term subsidies for specific rental units owned by private landlords”); SCHWARTZ, *supra* note 59, at 34-37 (charting decrease in federal assistance for affordable housing). It should be noted that the Low-Income Housing Tax Credit has financed more than two million units of affordable housing since 1987. See COMPTROLLER OF THE CURRENCY, U.S. DEP’T OF THE TREASURY, LOW-INCOME HOUSING TAX CREDITS: AFFORDABLE HOUSING INVESTMENT OPPORTUNITIES FOR BANKS 1 (2008), available at [www.occ.treas.gov/ftp/release/2008-10a.pdf](http://www.occ.treas.gov/ftp/release/2008-10a.pdf). While this is a great achievement, it does not come close to meeting the need for affordable housing. See SCHWARTZ, *supra* note 59, at 18-37 (summarizing serious affordability and housing condition issues in rental-housing stock). And despite its many successes, the recent economic downturn has destabilized the market for Low-Income Housing Tax credits. Ruth Simon et al., *Millions for Foreclosures*, WALL ST. J., June 18, 2008, at C12 (“Demand for tax credits has waned among banks and financial giants Fannie Mae and Freddie Mac because they haven’t been registering profits.”). One could argue that a benefit of the Joint Center’s proposal is that, unlike Low-Income Housing Tax credits that cannot function well in a contracting economy, the S-REIT would continue to operate. However, outside of a dire recession, this is much less of a concern and should not trump considerations of how subsidies perform under more normal circumstances.

99. AMERICA’S RENTAL HOUSING: HOMES FOR A DIVERSE NATION, *supra* note 12, at 22. The report describes the problem of smaller properties at risk for removal:

Over the ten years beginning in 1993, an estimated 2.3 million rental units (6 percent) were demolished or otherwise permanently removed from the inventory. Over half of these rentals were in older (built before 1960) one- to four-family buildings located in the nation’s most distressed neighborhoods . . . As might be expected, loss rates are higher for properties with such additional risk factors as low rent, long-term vacancies, and structural deficiencies. For older, smaller multifamily units, these added risk factors push the loss rate to 13 percent. Combining all the risk factors, including structural inadequacy, pushes the loss rate to over 20 percent.

*Id.* In gentrifying communities, rental housing may be taken out of service in order to convert it to condominiums. See generally Hans Lind & Anders Hellström, *Gentrification—An Overview of the Literature* (Div. of Bldg. & Real Estate Econ., Working Paper No. 38, 2003), available at [http://www.kth.se/polopoly\\_fs/1.19799!38.pdf](http://www.kth.se/polopoly_fs/1.19799!38.pdf).

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fate of the privately owned, unsubsidized rental stock that serves the vast majority of low-income renter households.”<sup>100</sup> Because financing costs are typically the biggest expense for multifamily properties, “issues related to the costs and availability of mortgage funds have important implications for the overall affordability of rental housing.”<sup>101</sup>

While the affordability problem is uncontroversial and well documented, it is unclear that the best solution for it is to reduce the financing costs of these landlords of last resort. Before undertaking the Joint Center approach, one must be confident that landlords will pass on these savings to their tenants and reverse the trend of shrinking the affordable housing stock. In other words, if the benefits of the reduction in landlord financing costs are intended to trickle down to tenants, one should be certain as to its rate of flow.<sup>102</sup>

James Follain and Edward Szymanoski challenge responses to the affordability problem like that of the Joint Center: “[I]t is wise to consider the relative importance of multifamily mortgage credit subsidy programs in an overall strategy to improve the delivery of housing services to low-income households.”<sup>103</sup> They argue that, for a variety of reasons, “[t]hese subsidy programs should not rank very high.”<sup>104</sup>

First, they argue that there is insufficient empirical evidence to support the argument for supply-side subsidies.<sup>105</sup> Second, they argue that an unacceptable portion of the subsidy flows to the housing providers and related industries.<sup>106</sup> Third, they argue that many supply-side subsidies are subject to improper political interference.<sup>107</sup>

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100. AMERICA’S RENTAL HOUSING: HOMES FOR A DIVERSE NATION, *supra* note 12, at 21-22 (also noting that this “affordable inventory consists primarily of single-family and small multifamily units”).

101. Schnare, *supra* note 22, at 4.

102. Cf. WINNICK, *supra* note 38, at 172 (noting that indirect government aids for rental housing “must be channeled through the hands of an intermediary—the private investor” and that “[c]onstant vigilance and strict regulation are required to insure that benefits will not be absorbed before they reach the intended beneficiary”).

103. Follain & Szymanoski, *supra* note 33, at 173.

104. *Id.*

105. *Id.* at 174.

106. *Id.*

107. *Id.* (arguing that “[d]emand-side programs are less prone to this type of abuse in competitive markets for rental housing, which seems to be the typical situation”).

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Follain clearly outlines the argument against a “trickle down,” supply-side subsidized multifamily mortgage policy, based on a fundamental question: what is the price elasticity of the housing supply?<sup>108</sup> If the housing supply is elastic, then tenants may benefit from reductions in the cost of providing the housing.<sup>109</sup> But if it is inelastic, “the primary beneficiaries of such programs are likely to be builders, investors, and other supply-side agents.”<sup>110</sup> This is because reducing production costs for an inelastic supply should not result in price reductions—only an elastic and increasing supply would have such a result.<sup>111</sup> As the housing economics literature has not yet determined whether the housing supply is elastic, it is dangerous to implement public policy based on the assumption that it is.<sup>112</sup>

After noting the limitations inherent in such supply-side, trickle-down policies, Follain and Szymanoski close their argument by pointing to the existence of more efficient solutions to some of the problems that a mortgage finance subsidy is intended to address.<sup>113</sup> One such solution, for instance, would be to pursue policies that directly benefit low- and moderate-income households and are targeted to reduce housing costs for tenants. Section 8, tenant-

108. Follain, *supra* note 10, at 543.

109. Elasticity of housing supply depends in turn on a variety of local factors, including rent, zoning, land use, and building regulations.

110. Follain, *supra* note 10, at 544. See EDWARD L. GLAESER & JOSEPH GYOURKO, *RETHINKING FEDERAL HOUSING POLICY* 64-81 (2008), for a discussion of the extreme variability of elasticity among American housing submarkets that results from variations in local land use regulation.

111. For example, if housing supply is elastic, developers would build more housing if it became profitable to do so as a result of decreased financing costs. This is because financing costs are a major element of overall housing cost.

112. Follain, *supra* note 10, at 544. Of course there is a certain amount of waste in any subsidy that does not involve a direct income transfer. If one were only choosing among producer subsidies, one must compare their comparative inefficiencies.

113. *Id.* Follain and Szymanoski suggest that

the complexity of multifamily lending can be reduced by simplifying the rules and regulations surrounding nonprofit housing development organizations. Local governments can also be encouraged to develop housing codes that are more accommodating to projects for low-income households. Another idea usually favored by economists is a well-structured demand-side voucher program that encourages recipients to search the market for good and affordable housing. This type of subsidy program is usually simpler to implement than subsidized lending programs and is more likely to be successful.

*Id.*; see Ellickson, *supra* note 94 (comparing efficacy of vouchers to inclusionary programs).

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based rent vouchers are the most well known of such subsidies.<sup>114</sup> One could achieve similar results by providing a tax credit for rent payments by low- and moderate-income families. Ultimately, the concerns set forth by Follain and Szymanoski regarding multifamily mortgage subsidy programs in general must be addressed before a federal or state government should implement a new program of subsidized, multifamily mortgage finance for small buildings in particular.

### B. *The Market Failure Rationale*

Follain and Szymanoski also explore “market failure” as an alternate rationale for government intervention in the multifamily mortgage sector.<sup>115</sup> In particular, they note that

[i]t is difficult to make a case for government intervention in the multifamily mortgage market when using the standard model of market failure, given the efficiencies of modern financial markets. The case for intervention in the financial markets, if one is to be made, is more subtle and requires a model in which uncertainty about some future events—for example, mortgage defaults—is explicit. Market failure in models with uncertainty is caused by two broad categories of factors in the credit markets: uninsurable risks and information costs.<sup>116</sup>

The question, then, is whether the small multifamily mortgage market suffers from uncertainty because of uninsurable risks or in-

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114. See generally RICHARD HILTON ET AL., EVALUATION OF THE MARK-TO-MARKET PROGRAM 1 (2004), available at <http://www.huduser.org/Publications/pdf/M2MEva.pdf>. The authors note,

In 1974, Congress enacted Section 8 “Lower Income Rental Assistance” under the United States Housing Act, a program that could be either project-based or tenant-based. Rather than providing a fixed subsidy, tenants would generally pay 25 percent of their income (later increased to 30 percent) towards their rent and the government would pay the difference.

*Id.*

115. Follain & Szymanoski, *supra* note 33, at 154. The authors describe a market failure as follows:

[W]hen the market does not provide the quantity of a particular good or service at which the marginal social benefits of another unit equal the marginal social costs of producing that unit. In such a situation, the benefits to society of having one more unit exceed the costs of producing one more unit; thus, a rationale exists for some level of government to intervene in the market and expand the output of this good.

*Id.*

116. *Id.*; see Vandell, *supra* note 10, at 322 (arguing that the most compelling argument “for government involvement in multifamily finance comes by way overcoming information voids”).

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formation costs. While researchers in the 1980s and 1990s found that there was not enough information for multifamily mortgage underwriters to make informed decisions,<sup>117</sup> this seems to be much less the case today.<sup>118</sup> To the extent that there is a market failure in the multifamily mortgage market, it is caused in part by the large number of originators in the small multifamily submarket. Such a low-concentration market increases transaction costs for secondary market investors seeking to conduct due diligence on many mortgages with different terms. As opposed to the RMBS market, there is a great deal of variety in multifamily mortgage documents, which increases due diligence and legal review costs for underwriters and securitizers.<sup>119</sup>

A final question is, if one were to generally support multifamily mortgage subsidies, whether smaller multifamily buildings should be subsidized at the expense of larger buildings. This is an important issue in the debate over whether to provide new supports for this housing stock, as smaller multifamily buildings may be less

117. See, e.g., Amy D. Crews et al., *The Distribution of Multifamily Mortgage Originations: What We Know and Why We Care*, 6 J. HOUSING ECON. 334, 365 (1997) (“Without better information, further development of a secondary multifamily mortgage market is likely to go slowly and lag far behind the single-family mortgage market.”); Schneider & Follain, *supra* note 52, at 49-50 (“[R]esearch indicates that small projects make up a niche market that is difficult and uneconomical to serve through standard multifamily lending practices.”).

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118. AMERICA’S RENTAL HOUSING: THE KEY TO A BALANCED NATIONAL POLICY, *supra* note 3, at 14.

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119. See, e.g., Schneider & Follain, *supra* note 52, at 50. The authors note, “The costs to investors of due diligence on nonstandardized loan pools of small project mortgages eliminate many pricing advantages of a structured transaction. Efforts to increase standardization could secure more access to efficient sources of long-term capital. However, standardization may prove difficult to accomplish because of the heterogeneity of small project borrowers and the flexibility required to underwrite small project loans.”

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*Id.*; see also Jean L. Cummings, *Developing a Secondary Market for Affordable Rental Housing: Lessons from the LIMAC/Freddie Mac and EMI/Fannie Mae Programs*, 4 CITYSCAPE: J. POL’Y DEV. & RES. 19, 20 (1998) (“An active secondary market requires standardization of the mortgage contract, underwriting and mortgage documents”). In January 2009, the Joint Center made a related market failure argument—that private lenders exit the multifamily market during credit crises and government instrumentalities such as Fannie Mae and Freddie Mac are needed to provide liquidity. MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at 5. Given the problems faced by Fannie Mae and Freddie Mac during the current credit crisis, this argument is less than compelling. See David Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. (forthcoming 2010), available at [http://works.bepress.com/david\\_reiss/25](http://works.bepress.com/david_reiss/25).

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efficient providers of affordable housing than larger ones.<sup>120</sup> To answer that question, one should compare the cost of subsidizing a unit of a small multifamily building to prevent it from being taken out of service to the cost of subsidizing a unit of a large multifamily building to prevent it from being taken out of service. In all likelihood, it is more efficient to preserve the unit in the larger building.<sup>121</sup> After all, large buildings bring to bear an economy of scale

120. William Apgar and Shekar Narasimhan argue that the smaller units in particular should be preserved. For example:

With new construction focused on expanding the supply of more expensive apartments in large multifamily structures, the ongoing demolition and inventory losses of rental units in older small multifamily structures is rapidly depleting the available supply of affordable rental housing. Most of the privately-owned small multifamily rental stock was built at least 30 years ago when construction techniques and capital markets were less sophisticated and households were less affluent. Much of this inventory is now in need of substantial repair. According to the American Housing Survey, 3 million private market rental units have severe structural deficiencies and are at risk of loss.

APGAR & NARASIMHAN, *supra* note 1, at 6. In addition to the criticisms set forth in the text above, Apgar and Narasimhan fail to explicitly address the filtering process that occurs as newer, more expensive units are added to the existing housing stock and the extent to which that addition to the overall housing supply offsets inventory losses of older, small multifamily units. See Matthew Edel, *Filtering in a Private Housing Market*, in READINGS IN URBAN ECONOMICS 204, 204 (Matthew Edel & Jerome Rothenberg eds., 1972) (defining filtering). They also fail to account for the fact that developments in the housing finance market such as the FHA-insured mortgage have allowed “the average developer to build on a larger scale.” WINNICK, *supra* note 38, at 159.

121. In order to study whether smaller buildings are less efficient tools for preserving affordable housing, one would need to control for the quality of the housing provided by smaller and larger buildings. Once that is done, it is very likely that the finding would be that larger buildings are more efficient. See THE STATE OF THE NATION’S HOUSING (2006), *supra* note 9, at 22 (noting that over the 1990s and 2000s “new multifamily rental construction has shifted decidedly toward larger structures”). A further consideration is whether lower-density housing has positive externalities that should factor into any discussion of subsidizing small apartment buildings. This appears to be a largely unexplored area of study. There have been numerous studies, however, that evaluate the individual and community benefits of residential homeownership, as compared to rental tenancy. See, e.g., ROBERT D. DIETZ, THE SOCIAL CONSEQUENCES OF HOMEOWNERSHIP (Homeownership Alliance, 2003), available at [www.newtowncdc.org/pdf/social\\_consequences\\_study.pdf](http://www.newtowncdc.org/pdf/social_consequences_study.pdf) (surveying existing scholarship drawn from social sciences, medicine, psychology, and other academic fields). Additionally, there is scholarship comparing the economic and health outcomes of moving families from high-poverty neighborhoods to low-poverty areas. See Jeffrey Kling et al., *Moving to Opportunity and Tranquility: Neighborhood Effects on Adult Economic Self-Sufficiency and Health from a Randomized Housing Voucher Experiment* 4-5 (Harvard Univ. John F. Kennedy Sch. of Gov’t, Faculty Research Working Paper Series RWP04-035, 2004), available at <http://ssrn.com/abstract=588942> (finding significant mental health benefits, some physical benefits, and no substantial economic benefits from participation in housing mobility program). It remains, however, a completely open question whether hous-

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that will tend to make them run more efficiently.<sup>122</sup> In either case, however, if the housing supply is relatively inelastic it is unlikely that even a generally available subsidy for multifamily properties is an efficient way to reduce the rate of loss to the affordable multifamily housing supply.<sup>123</sup> The imposition of some form of rent regulation on the subsidized housing would be necessary to ensure that it remained affordable.<sup>124</sup>

Apgar and Narasimhan have given form to the repeated calls by housing advocates to subsidize financing costs for small apartment buildings. To give this proposal its due, it does attempt to address aspects of the efficiency argument. To that end, Apgar and Narasimhan argue that the proposal would “facilitate the ownership transfer of the critically important small-multifamily rental inventory from individual owner to institutional investor, and in doing so help gain needed scale economies to reduce the costs of property management, repair and maintenance.”<sup>125</sup> It is highly uncertain, however, whether the economies of scale contemplated by such a model would in fact be achieved: one private company that be-

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ing density alone, controlling for all other factors, has an impact on residents sufficient to prioritize subsidies for small apartment buildings over those for larger buildings.

122. See MEETING MULTIFAMILY HOUSING FINANCE NEEDS, *supra* note 2, at 2 (citing efficiencies in delivering social services, improving physical infrastructure, and achieving energy independence and sustainable development goals via multifamily communities versus single-family housing). It is reasonable to assume that such efficiencies would be amplified, to some degree, in larger-scale multifamily housing. Apgar and Narasimhan readily admit that “[a]vailable evidence suggests the presence of significant economies of scale in the operation of larger buildings.” Apgar & Narasimhan, *supra* note 1, at 22. Indeed, the heart of their proposal is to duplicate the efficiencies of larger buildings by pooling smaller properties. *Id.* at 21-24, 28. However, as argued above, there are more efficient means of promoting the overarching goal of affordable housing.

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123. Notwithstanding this concern about the small multifamily market, it is not unreasonable to conclude, along with James Follain and Edward Szymanoski, that “standard contracts and data systems are public goods and government may want to invest in their development.” Follain & Szymanoski, *supra* note 33, at 161. Such an investment would obviously be much more modest than an ongoing subsidy to landlords themselves.

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124. To be clear, Apgar and Narasimhan’s S-REIT proposal does not call for mandatory subsidized rents or tenant income limits on the units owned by the S-REIT. While writing that affordability could be enhanced by combining the S-REIT program with rental subsidies, at base the program relies on market mechanisms to preserve affordable housing: “Even without subsidy, the [S-REIT] approach would help stem the loss of many small multifamily properties. In doing [so,] it alleviates the ongoing pressure on market rents that undermine the well being of the nation’s lowest income renters.” Apgar & Narasimhan, *supra* note 1, at 27.

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125. Apgar, *supra* note 90, at 55.

lieved that it could achieve such economies of scale has found that it is much more difficult than it had foreseen.<sup>126</sup>

#### CONCLUSION

While it is incontrovertible that small-apartment-building owners are not all slumlords and social parasites, the argument in favor of subsidizing the financing costs for such property owners has not been won. At best, its proponents might argue that it is a *realpolitik* response to the fact that direct subsidies to the poor are politically impractical, so it is better to support an industry—the housing industry—that provides services to the poor and is organized enough to defend those subsidies.<sup>127</sup>

For a more principled defense, proponents of small-apartment-building subsidy programs will need to respond to the concerns outlined above: is it a relatively efficient subsidy? Is it responding to a market failure? Those who favor such subsidies appear to have succumbed to a logical fallacy: they argue that because small buildings provide affordable housing and are at risk of loss, the most efficient way to protect affordable housing is to preserve these small buildings. For the reasons outlined above, that conclusion does not follow: the indiscriminate subsidy of financing costs for the owners of small multifamily buildings has not been demonstrated to be good public policy. More carefully targeted uses of government subsidies are therefore warranted to achieve housing affordability for low- and moderate-income households.

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126. See James R. Hagerty, *Beware the Foreclosure Allure—Redbrick's Model of Scattered Bets Is Cautionary Tale*, WALL ST. J., Sept. 24, 2008, at C19 (noting that private-sector investor in scattered small apartment buildings did not achieve economies of scale but, rather, faced high costs).

127. Ellickson, *supra* note 94, at 30-31.